

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 04-0421
Use Tax
For Years 2001, 2002, 2003

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ISSUE

I. Use Tax—Agricultural exemptions

Authority: IC § 6-8.1-5-1(b); IC § 6-2.5-2-1; IC § 6-2.5-5-1; IC § 6-2.5-5-2; IC § 6-3-1-3.5(a); 45 IAC 15-5-3(8); 45 IAC 2.2-2-1; 45 IAC 2.2-2-2; 45 IAC 2.2-5-1; 45 IAC 2.2-5-2; 45 IAC 2.2-5-3; 45 IAC 2.2-5-4; 45 IAC 2.2-5-6; 26 U.S.C. § 62; 26 U.S.C. § 165; 26 U.S.C. § 183

Taxpayer protests the assessment of use tax on items used in producing agricultural commodities, specifically alpaca fleece, based on the audit's determination that taxpayer's alpaca ranch was a "hobby," not a business engaged in for profit.

STATEMENT OF FACTS

Taxpayer owns and operates an alpaca ranch. At the time of the audit, taxpayer had seventeen alpacas, weighing between 125-200 pounds each and each producing approximately four pounds of fleece per year. Taxpayer breeds the animals to increase the size of the herd, a process known as "alpaca compounding," keeping progeny instead of selling the babies for profit. Once taxpayer's herd gets to the size he wishes to maintain, he will start selling animals. As of the date of the hearing, six of his breeding females were expecting foals to be delivered any day. Breeders show their animals at various places; values depend on breeding lineage, quality of fleece and color, and any unique physical features in the animals' physical appearance, fleece, or progeny.

Taxpayer, in business since 1998, is a member of an alpaca owners association, attending fairs and festivals since 2001. The co-op takes in fleece from the members, cleans it, and turns the fleece into blankets, throws, and various items of clothing. Members purchase the items at wholesale and sell them at retail at fairs and festivals. Taxpayer did not register as a retail merchant with the Department until 2002. Sales tax was not collected and remitted to the state until then. The audit assessed gross retail tax; taxpayer is not protesting this part of the assessment. Taxpayer is protesting the assessment of use tax on items used in producing an agricultural commodity, alpaca fleece.

The audit's rationale for assessing use tax was that taxpayer operated the ranch as a "hobby." Additional facts will be added as necessary.

I. Use Tax—Agricultural exemptions

DISCUSSION

Taxpayer protests the assessment of use tax on items purchased and used in producing agricultural commodities, specifically alpaca fleece. Taxpayer argues that most of the items in question are entitled to the agricultural exemptions outlined in Indiana's tax statutes and regulations. Taxpayer concedes that there are items that are not available for exemption, and agrees with some of the assessment; see, Letter of Protest dated November 2, 2004. The audit's rationale for assessing the gross retail tax and denying the exemptions were based on the determination that taxpayer operated a "hobby" ranch.

As a preliminary matter, the Department must look at the so-called "hobby farm" issue as it relates to use tax. First of all, the federal statutes are concerned with income taxes and allowable loss deductions from income; there is nothing in the federal statutes showing any relevance to either gross retail or use taxes. There is also nothing in the federal statutes that would have any impact on the availability of exemptions from gross retail and use taxes.

IC § 6-3-1-3.5 defines individual adjusted gross income tax in terms of Section 62 of the Internal Revenue Code, "modified as follows." Section 62 begins with an individual's gross income tax "minus the following deductions." So, in order to arrive at an individual's Indiana income tax liability, the Department looks at the federal adjusted gross income (gross income minus allowable deductions) and then modifies that figure according to IC § 6-3-1-3.5(a). One of the deductions allowable under the federal scheme is losses from the sale of property (section 62(a)(3)) which references sections 161 *et seq.* Section 161 provides that "there shall be allowed as deductions the items specified in this part," i.e., Part VI. Section 165 allows deductions for losses "incurred in any transaction entered into for profit;" (165(c)(2)); section 167 allows deductions for depreciation of property used in a trade or business. Taxpayer ascribes his lack of profitability to costs associated in building up his herd, known as "alpaca compounding," claiming that income from producing the agricultural commodity, alpaca fleece, will rise as the herd increases and sales of their fleece and fleece related products increase.

The audit disallowed the agricultural exemptions, arguing that since taxpayers operated the ranch as a "hobby" and not for profit under section 165(c)(2) and section 183, taxpayer was not entitled to the exemptions under Indiana's tax laws. Section 183 disallows deductions from income tax for activities not engaged in for profit. Section 183(d) creates a presumption that if income exceeds deductions for three of five consecutive years, then the activity is engaged in for profit. The audit applied section 183(d) in order to characterize taxpayer's agricultural activities as a hobby because the production of alpaca fleece showed no profit yet. Then the audit determined that since taxpayer's alpaca farm was a "hobby," taxpayer was not entitled to any exemptions from the state's gross retail or use taxes for any purchases made in connection with the alpacas. Pursuant to IC § 6-8.1-5-1(b) and 45 IAC 15-5-3(8), a "notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that

the proposed assessment is wrong rests with the person against whom the assessment is made.” Pursuant to IC § 6-2.5-2-1, a “person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.” *See also*, 45 IAC 2.2-2-1. Pursuant to IC §§ 6-2.5-3-1 through 6-2.5-3-7, an “excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana is the property was acquired in a retail transaction.” An exemption is provided in IC § 6-2.5-3-4 if “the property was acquired in a retail transaction and the state gross retail tax” was paid at the time of purchase. Taxpayers are personally liable for the tax. (IC § 6-2.5-3-6). IC § 6-2.5-3-7 provides that a “person who acquires tangible personal property from a retail merchant for delivery in Indiana is presumed to have acquired the property for storage, use, or consumption in Indiana;” therefore, the presumption of taxability exists until rebutted. *See also*, 45 IAC 2.2-3-4.

The standards for sustaining a claim for the agricultural exemption can be found at IC § 6-2.5-5-1, IC § 6-2.5-5-2, and 45 IAC 2.2-5-1 through 45 IAC 2.2-5-6. Both IC § 6-2.5-5-1 and IC § 6-2.5-5-2 exempt certain transactions involving particular items from the state’s gross retail and use taxes if the following requirements are met: taxpayer must acquire the property for “direct use in the direct production of food or commodities for sale” and be “occupationally engaged in the production of food or commodities” to be sold “for human or animal consumption.” IC § 6-2.5-5-1. Secondly, “transactions involving agricultural machinery or equipment are exempt. . . if” taxpayer “acquires it for use in conjunction with the production of food or commodities for sale” and is “occupationally engaged in the production of food or commodities which he sells for human or animal consumption.” IC § 6-2.5-5-2.

The following quote presents audit’s position on taxpayer’s activities:

Per 45 IAC 2.2-5-1, “Domestic animals and birds, pets, game animals and birds, *furbearing animals* (emphasis added in original), fish and other animals or poultry not directly used by the farmer in the direct production of food or agricultural commodities are subject to tax.” These animals do not produce any food or commodity other than their fleece. That same citation goes on to state that other various animals are exempt “provided that they are directly used by the farmer in the direct production of food or agricultural commodities *for sale* (emphasis added in original).

Since taxpayer does not meet the federal definition of farmer, he is not considered to be “occupationally engaged” in farming for State purposes. He does not meet the State definition of “farmer” because he does not raise food or commodities for human consumption nor does he sell commodities provided by the animals. Taxpayer is subject to sales/use tax on all purchases.

The agricultural exemption statutes, IC § 6-2.5-5-1 and IC § 6-2.5-5-2, provide in pertinent parts:

Transactions involving animals, feed, seed, plants, fertilizer, insecticides, fungicides, and other tangible personal property are exempt from the state gross retail tax if:

- (1) the person acquiring the property acquires it for his direct use in the direct production of food or commodities for sale; and
- (2) the person acquiring the property is occupationally engaged in the production of food or commodities which he sells for human or animal consumption or uses for further food or commodity production.

IC § 6-2.5-5-1

- (a) Transactions involving agricultural machinery, tools and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for his direct use in the direct production, extraction, harvesting, or processing of agricultural commodities.
- (b) Transactions involving agricultural machinery or equipment are exempt from the state gross retail tax if:

IC § 6-2.5-5-2

The remainder of the statute uses language similar to that contained in IC § 6-2.5-5-1 in that engaging in producing commodities for sale is key to the exemption.

Taxpayer's purchases/transactions fall within the coverage of both these statutes if the Department determines that alpaca fleece is an agricultural commodity. The agricultural exemption regulations, 45 IAC 2.2-5-1, 45 IAC 2.2-5-2, 45 IAC 2.2-5-3, 45 IAC 2.2-5-4, and 45 IAC 2.2-5-6 supply many useful definitions, but do not define "an agricultural commodity." Several of the regulations even go so far as to list out specific items as either exempt or non-exempt purchases, *see*, e.g., 45 IAC 2.2-5-4, but there is really no one definition of "an agricultural commodity." Therefore, a bit of extrapolation is required.

The closest the state regulations come to a definition of agricultural commodity is 45 IAC 2.2-5-1(b)(2): "Baby chicks, ducklings, geese, turkey poults, hatching eggs, pigs, hogs [*sic.*] lambs, sheep, livestock, calves, and cows are exempt from tax, provided that they are directly used by the farmer in the direct production of food or agricultural commodities for sale."

The audit conceded that taxpayer's alpacas "do not produce any food or commodity other than their fleece." [emphasis added]. Taxpayer's letter of protest, testimony at the hearing, and materials presented at the hearing, and documents submitted post-hearing all support taxpayer's contention, and the Department so finds, that alpaca fleece is an agricultural commodity no different than sheep or lamb's wool.

To summarize:

Taxpayer has sufficiently documented his subjective and objective intent to raise alpacas and produce their fleece (the agricultural commodities at issue) for profit. Taxpayer is not engaged in this activity as a hobby. Alpaca raising requires an initial investment of thousands of dollars.

Taxpayer is increasing the size of his herd (“alpaca compounding”) before he begins selling animals for profit. This is a clear business decision based on common sense. Taxpayer turns in alpaca fleece to the co-op which takes in fleece from its members, turns the fleece into thread and then into items members purchase at wholesale to sell at retail. Taxpayer submitted several catalogues where alpaca products of all kinds are available for customers to purchase at retail. Alpaca products are luxury items commanding top prices that will certainly enlarge taxpayer’s profit margins in the years to come. Alpaca fleece is an agricultural commodity no different than sheep or lamb’s wool, **and** is a renewable commodity—alpacas are sheared once a year and can produce fleece as long as they live and their fleece’s quality matches product quality and the tastes of the commercial market.

Pursuant to taxpayer’s November 2, 2004 Letter of Protest, the items listed in the following sections are exempt from the state’s gross retail and use taxes: sections 2, 3, 4, 5, 6, 8, 9, 10, and 11. Fencing in section 9 is not exempt; *see*, 45 IAC 2.2-5-2(d)(3); cutters, combs, and oil in section 10 are exempt for the reason stated.

FINDING

Taxpayer’s protest concerning the audit’s assessment of gross retail tax, based on agricultural exemptions for producing an agricultural commodity, specifically alpaca fleece, is sustained.